Study L-3060 February 7, 2000

Memorandum 2000-7

Duties Where Settlor of Revocable Trust Is Incompetent

As discussed briefly in Memorandum 2000-6, a number of issues have recently come to light involving the rights of beneficiaries under revocable trusts, particularly where the settlor's mental capacity is in doubt. It is surprising that this issue is just coming to the fore, but our initial research has not turned up much. Two recent California court of appeal cases have focused the attention of estate planners and the Commission on these issues: *Evangelho v. Presoto,* 67 Cal. App. 4th 615, 79 Cal. Rptr. 2d 146 (1998), which is the subject of the Commission's recent tentative recommendation, discussed in Memorandum 2000-6, and *Johnson v. Kotyck*, 76 Cal. App. 4th 83, 90 Cal. Rptr. 2d 99 (1999) (review filed Dec. 15, 1999), which held that the beneficiary of a revocable trust did not have the right to an accounting where a conservator had been appointed for the settlor and the trust remained revocable.

The Exhibit includes materials relating to the general issues, as well as the specific issues raised by *Evangelho* discussed in Memorandum 2000-6:

The recent cases reveal a gap in the coverage of the Trust Law (enacted on Commission recommendation, operative in 1986). The Trust Law rules relate mostly to irrevocable trusts, with some rules applicable to revocable living trusts usually phrased in terms of an exception to the general rules. In our years of working on the Trust Law, the Commission rarely focused on specific revocable trust issues. The emerging concern with settlors who lack capacity suggests that Probate Code Section 15800 does not provide sufficient guidance:

§ 15800. Limits on rights of beneficiary of revocable trust

15800. Except to the extent that the trust instrument otherwise provides or where the joint action of the settlor and all beneficiaries is required, during the time that a trust is revocable and the person holding the power to revoke the trust is competent:

(a) The person holding the power to revoke, and not the beneficiary, has the rights afforded beneficiaries under this division.

(b) The duties of the trustee are owed to the person holding the power to revoke.

Comment. Section 15800 … has the effect of postponing the enjoyment of rights of beneficiaries of revocable trusts until the death or incompetence of the settlor or other person holding the power to revoke the trust. See also Section 15803 (holder of general power of appointment or power to withdraw property from trust treated as settlor). Section 15800 thus recognizes that the holder of a power of revocation is in control of the trust and should have the right to enforce the trust. See Section 17200 et seq. (judicial proceedings concerning trusts). A corollary principle is that the holder of the power of revocation may direct the actions of the trustee. See Section 16001 (duties of trustee of revocable trust); see also Sections 15401 (method of revocation by settlor), 15402 (power to revoke includes power to modify). Under this section, the duty to inform and account to beneficiaries is owed to the person holding the power to revoke during the time that the trust is presently revocable. See Section 16060 et seq. (trustee's duty to inform and account to beneficiaries). The introductory clause recognizes that the trust instrument may provide rights to beneficiaries of revocable trusts which must be honored until such time as the trust is modified to alter those rights. See Sections 16001 (duties of trustee of revocable trust), 16080-16081 (duties with regard to discretionary trusts). The introductory clause also makes clear that this section does not eliminate the rights of beneficiaries of revocable trusts in situations where the joint action of the settlor and all beneficiaries is required. See Sections 15404 (modification or termination by settlor and all beneficiaries), 15410(b) (disposition of property on termination of trust with consent of settlor and all beneficiaries).

The section does not specify to whom duties are owed when the settlor lacks capacity or, put differently, whether beneficiaries have a right to accountings or to enforce the trust in a case where the settlor lacks capacity. (Terminology has changed in the last 15 years; statutory language is now generally phrased in terms of capacity rather than competence.) The court in *Johnson v. Kotyck*

resolved the issue by favoring the conservator and rejecting the petition by a trust beneficiary, even though the conservator had not actually obtained authority to revoke the trust. The staff thinks this is the correct reading of the statutes, although the statute could use further clarification. It does not say what the rule is where the trust is *potentially* revocable because the settlor is still alive although lacking capacity.

The current Uniform Trust Act draft is consistent with *Johnson's* reading of the California statute but also answers the unaddressed issue in our statute. (See UTA draft Section 604 and discussion at Exhibit pp. 1-2.) The UTA draft gives the "rights of beneficiaries" to the beneficiaries themselves while the settlor does not have capacity, *unless* the settlor "is represented" by an agent or conservator who is a person other than the trustee. **This looks to the staff like a good starting point**, although we think more may be needed than "is represented."

At this stage, the staff has not prepared a detailed staff draft because we are still researching the issues and gathering information from the experts. We understand that the issues have been the subject of vigorous discussion among the members of the State Bar Estate Planning, Trust and Probate Law Section Executive Committee, as indicated in the letters from our liaison, Don Travers. (See Exhibit pp. 3-7.) The issues presented by *Johnson v. Kotyck* have also been discussed on the ABA Probate and Trust Law mailing list, with no clear consensus. Jeff Strathmeyer has pointed out the difficulty of limiting the potential rights of the beneficiaries under Section 15800 based on the mere fact that a conservator has been appointed, since it is speculative whether the conservator has or will seek authority to revoke the trust. In other words, conservatorship does not appear to be a very efficient means of protecting the trust. Ken Petrulis suggests phrasing the exception in terms of a "presently exercisable" power to revoke, which might help address the concern with conservatorship powers. (Exhibit p. 8.) This approach would also help resolve the doubt that may arise with regard to the power of an attorney-in-fact under a durable power of attorney.

Similar language appears in Probate Code Section 15803

> **§ 15803. Rights of holder of power of appointment or power to withdraw**
>
> 15803. The holder of a presently exercisable general power of appointment or power to withdraw property from the trust has the rights of a person holding the power to revoke the trust that are

provided by Sections 15800 to 15802, inclusive, to the extent of the holder's power over the trust property.

Comment. Section 15803 … makes clear that a holder of a power of appointment or a power of withdrawal is treated as a person holding the power to revoke the trust for purposes of Sections 15800-15802 in recognition of the fact that the holder of such power is in an equivalent position to control the trust as it relates to the property covered by the power.

Others have focused on the fact that the trust is still revocable in this situation, whether by action of the conservator or the settlor's regaining capacity. From this perspective, the settlor is still the only person with a present beneficial interest and the beneficiaries only have an expectancy — this is the will substitute approach. As discussed in Memorandum 2000-6, other commentators prefer to emphasize the revocable trust's role as a substitute for conservatorship, which suggests that some mechanism other than conservatorship is needed in order to protect against abuse by a trustee or others during a period when the settlor lacks capacity.

Other difficult issues arise where it is unknown whether the settlor lacks capacity, or looking back, it is difficult to determine what periods the settlor had capacity. Arguably, broadening accounting rights is necessary to cover these situations because appointment of a conservator is too burdensome or drastic. But we should not lose sight of the fact that there are privacy interests entitled to some respect. One of the reasons people set up revocable trusts is to avoid interference from others, including (or most importantly) the contingent beneficiaries.

The staff will continue to work with interested persons on these issues. Mr. Travers has suggested convening a study group to attempt to develop a consensus approach to present to the Commission for review at a later time. The staff recommends following this course. If consensus cannot be reached, we will present the Commission with the best alternatives so that the Commission can decide whether to make a tentative recommendation.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

Exhibit

EXCERPT FROM UNIFORM TRUST ACT (OCT. 1999 DRAFT)

SECTION 604. SETTLOR'S EXERCISE OF RIGHTS OF BENEFICIARIES; PRESENTLY EXERCISABLE POWERS OF WITHDRAWAL.

(a) Except as otherwise provided in subsection (b), while a trust is revocable, rights of the beneficiaries are subject to the control of, and the duties of the trustee are owed exclusively to, the settlor.

(b) While a trust is revocable and the settlor does not have capacity to revoke the trust, rights of the beneficiaries are held by the beneficiaries unless the settlor is represented by an agent under a durable power of attorney, a [conservator], or a [guardian] who is someone other than the trustee.

(c) During the period the power may be exercised, the holder of a power of withdrawal has the rights of a settlor of a revocable trust under this section to the extent of the property subject to the power.

Comment

This section has the effect of postponing the enjoyment of rights of beneficiaries of revocable trusts until the death or incapacity of the settlor or other person holding the power to revoke the trust. This section thus recognizes that the settlor of a revocable trust is in control of the trust and should have the right to enforce the trust. Because of this degree of control, the trustee may also rely on a written direction of the settlor, even if contrary to the terms of the trust. Alternatively, the written direction of the settlor might be regarded as a modification of the trust.

Under this section, the duty to inform and report to beneficiaries is owed to the settlor of a revocable trust as long as the settlor has capacity. See also Section 813 (trustee's duty to inform and report to beneficiaries).

If the settlor loses capacity, subsection (b) provides that the duty to inform and report to beneficiaries is owed to the beneficiaries and not the settlor unless the settlor is represented by an agent under a durable power of attorney, conservator, or guardian who

is someone other than the trustee. If the settlor is so represented, per Article 3, notices which would have been provided to the settlor may be given to the agent, conservator, or guardian, as applicable, and the agent, conservator, or guardian may give a consent on behalf of the person represented.

Subsection (c) makes clear that a holder of a presently exercisable power of withdrawal has the same powers over the trust as the settlor of a revocable trust. Equal treatment is warranted due to the holder's equivalent power to control the trust.

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The October 21, 1999, memorandum from David English, Reporter on the UTA, contains the following discussion of this section:

> JEB, the ABA Task Force, and the ACTEC Committee on State Laws are divided over extent to which beneficiaries of revocable trust should have rights of beneficiaries upon incapacity of settlor. Three views have been expressed: (1) as long as trust is revocable, rights of beneficiaries should be held exclusively by the settlor, whether or not the settlor is incapacitated. Result is to treat revocable trust identically to a will, under which devisees have no rights until testator's death; (2) upon incapacity of settlor, beneficiaries have rights of beneficiaries whether or not an agent or conservator has been appointed: and (3) upon incapacity of settlor, rights of beneficiaries continue to be held by the settlor only if there is an agent or conservator in office who is someone other than the trustee (this is approach of present and prior draft).
>
> The ACTEC Committee on State Laws suggests that it be made clear that this section is subject to contrary provision in the terms of the trust. Also, Stan Kent, looking at Section 813(f), suggests that one solution to the problem of the incapacitated settlor is to clarify that settlor, in terms of the trust, can appoint someone to act on settlor's behalf.

ESTATE PLANNING, TRUST AND PROBATE LAW SECTION

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January 26, 2000

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Re: Revocable Trust Accounting Study (Study L-3059)
Duties Where Settlor of Revocable Trust is Incompetent (Study L-3060)

Dear Stan:

As I told you when we talked yesterday, the members of the committee had a number of thoughts concerning the two projects referred to above.

1. I have enclosed a copy of part of a report made by our Litigation Committee. The Executive Committee approved the Litigation Committee's work in principle, subject to more drafting. Also, it was suggested that the words "or subject to undue influence or fraud" should be inserted after the word "incapacitated" in the proposed change to Probate Code section 16064.

2. Someone also suggested that perhaps any trustee who is not the settlor should have a duty to account, or at least keep books and records so that an accounting could be prepared later if required by the court.

3. One member mentioned that there are a number of Welfare and Institutions Code sections which will cross over to this area. I haven't yet researched this point, but if I find anything I will let you know.

In general, this is a difficult area and a lot of work will be needed to come up with a viable proposal to improve existing law. When your memorandums 2000-6 and 2000-7 are completed I will contact you again.

Very truly yours,

Donald R. Travers

DRT:srm
Enclosure

cc: James B. Ellis
Marshal A. Oldman

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DISCUSSION OF LRC PROPOSAL

In regard to the problems presented by Evangelho and the LRC proposal to reverse its ruling, the Committee discussed the competing public policies of privacy and simplicity of administration versus protection for beneficiaries from fraud. In most matters, reversal of Evangelho would foster the expectation of privacy and prevent undue examination of a person's private finances simply because the assets are held in a revocable trust which might in the future provide benefits to persons who have a mere expectancy during the settlor's lifetime. In such matters, the Committee reached a consensus that we should not provide greater protections for beneficiaries of living revocable trusts than beneficiaries under wills.

However, Evangelho focuses in part on the problem of a third person trustee, in that case a child, who was acting either as trustee or acting through an allegedly incapacitated parent to enrich himself to the detriment of other siblings. Evangelho provides that an accounting can be obtained from a trustee who was acting for the settlor at a time that the trust was still revocable. The impetus for the LRC reversal of Evangelho is that greater rights should not be granted to beneficiaries of trusts than of wills. At the same time, the Committee was concerned that the proposed language of the statutory fix for Evangelho may place the improperly acting trustee of a revocable trust in a better position to protect himself than if the same person was acting as an agent under a power of attorney for the same assets existing outside of a trust. Based on the level of fraud that exists in the administration of revocable trusts, the Committee determined that it was important to avoid statutory protections for a trustee who was acting during a period of revocability with an incapacitated settlor. For this reason, the Committee suggests that the ExCom propose the following language for paragraph (b) of existing Section 16064 of the Probate Code:

"..., regardless of whether the trust has become irrevocable unless the beneficiary of a trust can show good cause for a court to order such accounting that the court determines is proper under the circumstances upon a showing that the person holding the power to revoke was incapacitated at the time of a particular transaction or transactions."

The Committee believes that the foregoing will provide protection for beneficiaries of trusts which were managed by third parties and the settlor was incapacitated at the time that the actions in question took place. The language also allows the court flexibility to order a more limited accounting than the general accounting that is normally required for a trustee or other fiduciary. The Committee believes that the additional language will place trustees of revocable trusts on the same plain as agents acting under a durable power of attorney for an incapacitated person.

ESTATE PLANNING, TRUST AND PROBATE LAW SECTION

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February 1, 2000

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Dear Mr. Ulrich:

This letter will serve as a memorandum of our telephone conversation yesterday with reference to agenda items number 6, Revocable Trust Accounting, and number 7, Duties Where Settlor of Revocable Trust is Incompetent.

These two closely related topics were initially raised by the 1998 case Evangelho v. Presoto, 67 Cal. App. 4th 615. The Commission discussed the case in some depth during the August meeting in San Diego. Correspondingly, the case was discussed by the State Bar's Estate Planning, Trust and Probate Committee and at great length by our Litigation Committee. Another case, Johnson v. Kotyck (November 1999) 76 Cal. App. 4th 83 has dealt with similar issues.

It now appears that the issues are more difficult to resolve than any of us expected. It does seem clear that accountings should not be required of the trustee in a case in which the settlor or settlors are serving as trustee or co-trustee of a revocable trust. The situation is not so clear when there is a non-settlor trustee or co-trustee during a time when the settlor is or may be incompetent. Also, what about a case in which the settlor-trustee is alleged to have been subject

to undue influence or fraud. Then there are the problems posed when the settlor is under conservatorship and is statutorily disqualified from acting as trustee- can the conservator as such require an accounting or must the trust be amended under the substituted judgment provision of Probate Code section 2580.

I would suggest that it might be helpful to schedule a telephone conference with certain members of my committee before your Memorandum 2000-6 and 2000-7 are prepared. I would suggest including the chairpersons of our Litigation and Administration Committees, and John Hartog, who among other things is the author of California Trust Practice, published by Matthew Bender. I have discussed this suggestion with our Chairperson, Jim Ellis, and he agrees that this might be useful. I know that this will delay preparation of the Memorandums beyond the February 10/11 meeting, but I believe the delay will be worthwhile.

Please let me know if you want me to arrange the conference call. I will clear the date and time with you before I schedule it.

Very truly yours,

Donald R. Travers

DRT:srm

cc: James B. Ellis

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From: "Kenneth Petrulis" <kgp@gwtaxlaw.com>
To: "CLRC" <comment@clrc.ca.gov>
Subject: Revocable Trust Accountings
Date: Fri, 4 Feb 2000 16:36:00 -0800

First, I agree in principle that the result in Evangelo misinterprets existing law and must be corrected. However, I would suggest a slightly different approach. Under probate code section 24, a beneficiary of a trust is defined as a person with any present or future interest. As you point out in your recommendation, a person named as a beneficiary of a revocable trust has a mere expectancy and thus does not fall within the definition of Section 24. Until the trust becomes irrevocable they are only nominal beneficiaries who have an expectancy but not a beneficial interest under the trust. While the trust is revocable, the only beneficiary is usually the Settlor of the trust who because of the power of revocation, has the sole beneficial interest.

Unfortunately, some provisions of the trust law suggest that a person named in a revocable trust is a beneficiary, even when it is clear that they have no enforceable interest meeting the requirements of Section 24.

I would therefore take the position that the error of the Evangelo court was to allow an accounting for a period when the sole beneficiary of the trust was also the trustee. On the other hand, the law should be clear that when the Settlor/beneficiary of a revocable trust is not the trustee, the trustee may be required to account. I would therefore suggest the following changes to the trust law:

1. 16064(b) In the case of a beneficiary of a revocable trust, when the beneficiary is also the trustee,as provided in Section 15800, for the period when the trust may be revoked, regardless of whether the trust has become irrevocable.

2. 15800(a) The person or persons holding the power to revoke or presently exercisable power to enforce the terms of the trust or appoint trust assets are the sole beneficiaries of the trust.

Consistent with these changes, 15800(b) and 15803 are probably unnecessary and 15802 should be changed to indicate that the notice is in fact being given to the sole beneficiary.

I am submitting these comments as an individual. Comments from the BEVERLY HILLS BAR ASSOCIATION Probate Legislative committee will follow.

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